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POSSIBLE FUTURE WORK

Note by the Secretariat

Addendum

Cross-border insolvency

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INTRODUCTION

1. At the Congress on International Trade Law held in May 1992 in New York in the context of the twenty-fifth session of the Commission proposals were made that the Commission consider undertaking work on international aspects of bankruptcy. In describing one of the proposals it was stated that it may not be practical to think of unifying the bankruptcy laws since in the evolution of international law we were too far from the time when we could expect countries to have similar bankruptcy laws. However, it was said that problems could be reduced to a more manageable level by focusing at issues in the State where the assets were located, as contrasted to the State where the bankruptcy proceedings were initiated, and answering how those assets should be handled.

2. The purpose of this note is to assist the Commission to decide whether an in-depth study on the desirability and feasibility of harmonized rules in this field should be undertaken.

3. After the introductory section I, section II considers some legal issues that may give rise to problems due to a lack of harmony among national laws. Section III provides a brief description of work at the international level towards harmonization of laws in the area. Conclusions are set out at the end of the paper.

I. GENERAL REMARKS

4. Most legal systems contain rules on various types of proceedings that may be initiated when a debtor is unable to pay its debts. "Insolvency proceedings" is the generic expression used in this note for those types of proceedings. Two types of insolvency proceedings may be distinguished, for which a uniform terminology has not emerged.

5. In one type of proceedings (hereafter referred to as "liquidation"), a public authority, usually a court, and typically acting through an officer appointed for the purpose (referred to here as "bankruptcy administrator"), takes charge of the insolvent debtor's assets with a view to transforming non-monetary assets into a monetary form, distributing the proceeds proportionately to the creditors, and, at the end of the proceedings, liquidating the debtor as a commercial entity. In some States this is the only type of proceedings used. Other terms that are often used for this type of proceedings are for example, bankruptcy, winding-up, faillite, quiebra, Konkursverfahren. It may be noted, however, that terms such as bankruptcy might be understood as having a broader meaning which includes also composition proceedings as described in the next paragraph.

6. The other type of proceedings (hereafter referred to as "composition"), which is known in many but not all States, exists as an alternative to liquidation proceedings. The purpose of the alternative proceedings is not to liquidate the insolvent debtor, but to allow it to overcome the financial crisis and resume normal participation in commerce. Such proceedings, also usually carried out under the supervision of a court, are typically aimed at reaching an agreement, or composition, between the debtor and its creditors about relief that should allow the debtor to reorganize and restore its commercial viability. The relief may be in the

form, for example, of partial abatement of the claims against the debtor, prolongation of payments periods, or renegotiation of existing debtor's obligations. While such relief is being negotiated, the debtor enjoys protection from enforcement actions of creditors over the debtor's assets. It may be possible for composition proceedings to be initiated during liquidation proceedings. Other terms used for this type of insolvency proceedings are, for example, reorganization, arrangement, concordat préventif de faillite, suspensión de pagos, administración judicial de empresas, Vergleichsverfahren.

7. For insolvency proceedings to be initiated, a court order is typically needed. The initiative to open such proceedings may be taken by the insolvent debtor itself (voluntary insolvency) or by a creditor or creditors (involuntary insolvency). In some States the same type of insolvency proceedings apply to all insolvent merchants, whereas others use two types of proceedings, one for legal persons and another for merchants who are natural persons.

8. In many States, for a court to have jurisdiction to open insolvency proceedings, a certain link between the debtor and the State is required. That requirement may be satisfied, for example, if the debtor has in that State its principal place of business, residence, corporate seat or centre of administration, or if the debtor is registered as a company in the State. This type of insolvency proceedings is often referred to as "domiciliary" insolvency proceedings.

9. In addition to domiciliary insolvency proceedings, a good number of States allow the opening of insolvency proceedings even if the above-mentioned domiciliary link between the State and the debtor does not exist. This type of insolvency proceedings, often referred to as "non-domiciliary" insolvency proceedings, can be initiated in a State if, for example, some of the debtor's assets are in the State or if the debtor who is a natural person is passingly present in the State. Some States allow the opening of this type of proceedings in a broad spectrum of situations, while in others the possibility of holding such proceedings is more restricted. These insolvency proceedings can be carried out in parallel and independently from any domiciliary or other non-domiciliary insolvency proceedings initiated in another State.

II. SOME ISSUES IN CROSS-BORDER INSOLVENCIES

10. Cross-border insolvency is the term frequently used for insolvency cases in which the assets of the debtor are located in two or more States, or where foreign creditors are involved. The following sections A to G describe some areas of cross-border insolvency where problems may arise due to a lack of harmony among national rules.

A. Effect of liquidation proceedings in one State on assets located in another State

11. In the legislation of many States it is expressly stated, or it is understood, that liquidation proceedings opened in the State are to take effect over all the assets of the debtor, including the assets located abroad. The intention is that all the debtor's assets should be available to the administrator for establishing the pool of proceeds from which the creditors are to be paid. Some of these laws expressly indicate that such universal effect of liquidation proceedings results only from a domiciliary liquidation and not from a non-domiciliary one (see above, paras. 8 and 9).

12. There are, however, also national laws according to which the effects of domiciliary liquidation proceedings taking place in the State is restricted to the bankrupt's assets located in that State. Such a self-imposed restriction has been criticized because it hinders the access of the creditors to all the assets of the debtor.

13. Many States claiming universal effect for their liquidation proceedings recognize, in varying degrees and with some limitations, the universal effect also for liquidation proceedings opened abroad. There are, however, also States which, while claiming universal effect for their liquidation proceedings, deny such effect to foreign liquidation proceedings.

14. In the States that are ready in principle to recognize foreign liquidation proceedings, a usual condition for recognition is that there be a substantial link between the bankrupt and the State of the liquidation proceedings. That link may be, for example, that the foreign liquidation proceedings are domiciliary proceedings (see above, para. 8) or that the bulk of the bankrupt's assets is located in that foreign State.

15. According to some national laws, for foreign liquidation proceedings to be given effect, it is necessary to obtain a formal recognition of the foreign court decision opening the proceedings. According to those laws, such recognition is usually subject to the same procedures as any recognition of a foreign court decision. In other national laws, the recognition of foreign liquidation proceedings, while being subject to certain controls (e.g., as to jurisdiction of the foreign court and the observance of fundamental principles of procedure), does not require a formal recognition procedure.

16. Even if liquidation proceedings taking place in a State is not given a full and formal effect by the States in which the bankrupt debtor has assets, there may be several ways to enhance the cross-border effectiveness of the liquidation proceedings. For example, if the person who is currently holding the bankrupt's assets is amenable to the jurisdiction of the State where the liquidation proceedings are taking place, the bankruptcy administrator may institute proceedings against that person for the surrender of those assets. In addition, the bankrupt debtor may be under a duty, or may be ordered by the court conducting the insolvency proceedings, to take the steps necessary to make all its assets abroad available to the bankruptcy administrator. Furthermore, a creditor who obtained in a foreign State full payment from the bankrupt debtor, and who is amenable to the jurisdiction of the State where the liquidation proceedings are taking place, might, under certain circumstances, be obligated by the court to surrender that payment to the administrator and accept to be paid under the same terms as the other creditors.

B. Cross-border judicial assistance

17. When insolvency proceedings are initiated in a State, the administrator of the debtor's assets or an interested creditor may wish to obtain assistance from a foreign court. The assistance, to the extent it is available, may consist, for example, of turning over to a foreign bankruptcy administrator assets belonging to the insolvent debtor; publicizing foreign insolvency proceedings; suspending a creditor's legal action against the debtor that would, contrary to the principle of equality among creditors, diminish the bankrupt's assets; granting measures of protection against

debtor's assets; staying an effort by a creditor to create or enforce a security interest regarding a debtor's property; challenging preferential transfers of property or transfers alleged to be fraudulent; opening local ancillary insolvency proceedings; or allowing the administrator to act in behalf of foreign creditors.

18. The current rules and practices on cross-border court assistance in insolvency matters are rather diverse. Some States, in particular those that deny effect to insolvency proceedings declared in a foreign country, are not prepared to entertain formal requests for assistance (e.g., by a foreign bankruptcy administrator). In those States, the only way for a foreign bankruptcy administrator to make local assets available to foreign creditors, or to obtain another form of assistance, may be to initiate local insolvency proceedings, in which the foreign creditors would then be able to participate, either themselves or through the foreign bankruptcy administrator.

19. Some States have rules that specifically address court assistance in cross-border insolvencies. Differences, however, exist as to the types of assistance available. In other States no specific rules exist on court assistance in foreign insolvencies. Furthermore, in some States cross- border court assistance is subject to fairly specific conditions, while in others this is a matter left largely to the discretion of the court.

C. Right of all creditors to participate in insolvency proceedings

20. Many national laws allow in principle all creditors, domestic and foreign, to participate in insolvency proceedings; however, foreign authorities are usually precluded from lodging public-revenue claims arising, for example, from tax, penal and similar obligations. Yet, in some States this preclusion does not apply if part of the debtor's assets originate from the State lodging its revenue claims.

21. According to the law of some jurisdictions, the principle of non-discrimination among creditors applies only for claims that are payable in the State in which the insolvency proceedings are taking place; in those jurisdictions, any claims payable exclusively abroad are subordinated to the claims payable in the State of the insolvency proceedings.

D. Priority rules in distribution of assets

22. Many national laws classify claims against the bankrupt with the purpose of establishing an order of priority among them. The claims granted the highest priority are to be satisfied from the bankrupt's assets in full before subsequent categories of claims can be paid.

23. Considerable differences exist among national laws as to the number and types of preferred categories of claims. The expenses of the liquidation proceedings and the fees of the bankruptcy administrator in many laws enjoy the highest priority. Specified fiscal claims by the authorities of the State where the liquidation proceedings take place are in many States also high on the priority list. The next priority is often given to claims for salaries by the bankrupt's employees, although in some States the preferential treatment is limited by an amount or by a maximum retrospective time- period for claims for arrears. Beyond these typical preferred categories of claims, the rules on subsequent preferred categories, defined by the type of creditors or transaction, are more diverse.

24. The question of priority of claims is generally determined by the rules of the State in which the liquidation proceedings take place, regardless of whether the case involves foreign creditors or assets surrendered from a foreign country. Such a conflicts rule means that a court, if it wants to respect priority expectations of creditors in liquidation proceedings that take place or may take place in its State, would be inclined not to surrender bankrupt's assets located in the State to a foreign bankruptcy administrator. The motives for refusing to surrender the assets are likely to be particularly strong when the assets requested to be surrendered would probably be consumed by the preferred fiscal claims by the State requesting the surrender. In this context, the preferred treatment of fiscal claims has been criticized, and it was argued that it would be easier to establish a workable system of cooperation between States in insolvency matters if the preferential treatment of fiscal claims were abolished or radically curtailed. It appears that such arguments may have led some States to restrict considerably the preferences accorded to such claims.

E. Cross-border compositions

25. In contrast to cross-border liquidation proceedings, in which an important issue is whether the proceedings opened in one State affects assets abroad, an important question in cross-border compositions is whether the terms of relief agreed upon in a composition in one State (e.g., abatement of claims) can be invoked by the debtor against a creditor in court proceedings in another State.

26. In many States, a clear answer to the question does not appear to have emerged in the legislation and case law. Opinions have been expressed that compositions are procedural agreements and that, as a result, they should have effect only in the country of origin. Another view is that, in the absence of an international agreement, a foreign composition should be recognized to the extent it concerns debts that are governed by the law of the State where the composition was concluded. Yet another view is that a composition should be binding on all those creditors who have participated or were given a possibility of participating in the composition. There is also a view that a foreign composition should be recognized under the same conditions as foreign liquidation proceedings. According to yet another view, one condition for recognition should be that the composition was carried out in a State with which the insolvent debtor has a close link (e.g., by having there the place of business, residence, centre of administration or the bulk of its assets); another condition should be that the composition was intended to encompass all creditors and that it did not discriminate among creditors or was not otherwise contrary to the public policy of the State where the composition is being invoked.

F. Recognition of security interests

27. Most national laws recognize that a creditor holding a security interest in an item of property included in the bankrupt's assets has a right to satisfy its claim by relying on the security interest, without having to surrender the proceeds for sharing with the other creditors. Such security interests, which can considerably diminish the availability of assets for meeting the claims of the unsecured creditors, are, for example, the retention

of title, pledge, assignment of a claim as a security 1/, mortgage, lien, or floating charge. Movable as well as immovable property may be subject to such security interests.

28. There are differences among legal systems as to the rules governing security interests. Differences concern, for instance, the types of security interests recognized in national laws, the formalities for establishing a security interest, the procedures for invoking a security interest, and the priority rules for cases when more than one creditor has a security interest in the same item.

29. Differences exist also as to the treatment of security interests in insolvency proceedings. The differences relate to issues such as: whether a particular type of security interest retains its effectiveness upon opening of insolvency proceedings; the right of the bankruptcy administrator with respect to the sale of the property subject to the security interest; the existence of any privileged claims enjoying priority over secured claims; and the conditions under which another creditor or the bankruptcy administrator may invalidate a security interest created during a specified time period before the opening of the insolvency proceedings.

30. In many national laws, security interests in tangible property are in principle considered to be governed by the national law of the State where the property concerned was located at the time of creation of the security interest. If that national law is different from the law governing the insolvency proceedings, a possible problem impeding the creditor to rely on the security interest may be that the security interest in question is not known in the national law governing the insolvency proceedings.

G. Impeachment of debtor's transactions prejudicial to creditors

31. Many States have rules that make it possible for the bankruptcy administrator or an interested creditor to set aside or modify a debtor's transaction that diminished the debtor's assets. Such transactions may be, for example, a sale of debtor's property on terms unusually favourable to the buyer, preferential payments of debts to selected creditors, or security interests created retrospectively for previously unsecured debts. National laws differ, for example, as to the types of transactions that may be affected, the types of remedies available to the bankruptcy administrator or an interested creditor, and the conditions for impeaching a transaction (e.g., the point in time before the commencement of the insolvency proceedings after which a transaction by the debtor becomes suspect and liable to impeachment, the terms of the transaction that make it impeachable, and knowledge by the debtor's contracting party about the possible insolvency of the debtor).

1/ Assignment of claims as a method of providing security to creditors is discussed in note A/CN.9/378/Add.3; para. 13 of that note refers to the previous work of the Commission in the area of security interests.

32. Difficult questions to which national laws give differing answers, or to which the answers are not settled, concern also conflicts of laws and conflicts of jurisdictions. The questions are, for example: whether, in a given State, a foreign bankruptcy administrator is entitled to request impeachment of a transaction or whether such a remedy is available only to a local bankruptcy administrator; whether a State would recognize a foreign court decision impeaching a transaction; and which national law is applicable to a claim for such a remedy (e.g., the law of the State where the insolvency proceedings take place, the law where the property in question is currently located or was located before the transaction, the law of the person who benefitted from the transaction or the law applicable to the transaction).

III. INITIATIVES TOWARDS REGULATION OF CROSS-BORDER INSOLVENCIES

A. Regional initiatives

1. Latin American States

33. In Latin America, three texts deal with international aspects of insolvency law: the Convention on Private International Law, Havana 1928 ("Bustamante Code") and two Treaties on Commercial International Law, 1889 and 1940 ("Montevideo Treaties").

(a) Bustamante Code

34. The Bustamante Code has been adopted by 15 Latin American States. It provides that the debtor's civil or commercial domicile is the link required for jurisdiction to open insolvency proceedings. If the debtor has one domicile, only insolvency proceedings in the State of the domicile are allowed; if the debtor has a commercial domicile in more than one State, proceedings can be opened in each of those States.

35. Provisions are included on: recognition in other contracting States of bankruptcy and composition orders; recognition of the powers of a bankruptcy administrator appointed in a foreign contracting State; recognition of foreign decisions setting aside or modifying transactions that were concluded within a specific period prior to the insolvency declaration and that prejudice the debtor's creditors.

(b) Montevideo Treaties

36. The relations between four Latin American States are governed by the Montevideo Treaty of 1889, while the relations between three Latin American States, of which one is also a Party to the 1889 Treaty, are governed by the Montevideo Treaty of 1940. The former provides rules for liquidation, while the latter provides guidance also for compositions, suspensions of payments and other analogous proceedings provided for in the contracting States.

37. Both Treaties refer to the debtor's commercial domicile as the required link for jurisdiction to open insolvency proceedings. If the debtor has a commercial domicile in other States, proceedings can be opened in each of those States.

38. Under the scheme of the Treaties, the authority of bankruptcy administrators, as determined by the laws of the State where the insolvency proceedings were opened, is recognized in all contracting States. Provisional measures can be enforced over property located in other States, and courts in those other States are to publicize the opening of the proceedings and the taking of the provisional measures. Provision is also made for local creditors in those States to petition for separate involuntary proceedings to be carried out in accordance with the law of the State where they are opened. Creditors can rely on security interests, in both immovable or movable property, before the court where the property is located, as long as those security interests were established before the opening of the insolvency proceedings.

2. Nordic Council

39. Under the auspices of the Nordic Council, the Nordic States concluded in 1933 the Convention between Denmark, Finland, Iceland, Norway and Sweden regarding Bankruptcy. The Convention was amended in 1977 and 1982.

40. Recognition is granted in all contracting States for bankruptcy proceedings opened in any contracting State where the bankrupt has its residence or registered office.

41. The Convention amalgamates all assets of the debtor in all contracting States into a single mass to be administered and distributed according to the rules of the State where the bankruptcy proceedings were opened. However, special preferences or security rights attached to the debtor's assets are to be governed by the law of the country where the assets concerned are located. Provision is made for publicizing the bankruptcy proceedings in other contracting States where assets of the debtor are located, preparation of an inventory of the debtor's assets, provisional measures, judicial assistance from authorities in other States, and recognition of judicial decisions, in particular for the purpose of confirming a composition with creditors.

3. Council of Europe

42. The member States of the Council of Europe concluded the European Convention on Certain International Aspects of Bankruptcy (Istanbul, 5 June 1990). Up to 1 June 1993, no State had adhered to it.

43. According to the Convention, the competence to open a bankruptcy is determined by the place where the debtor has the centre of its main interests; for companies and legal persons, unless the contrary is proved, the place of the registered office is presumed to be the centre of their main interests.

44. The main purpose of the Convention is to allow the bankruptcy administrator to act in other jurisdictions on behalf of the creditors, to take provisional measures, and to institute legal proceedings in any of the member States. In addition, when a debtor has been declared bankrupt in a State (main bankruptcy), the Convention provides that the debtor may, by virtue of this fact alone, be declared bankrupt in another contracting State (secondary bankruptcy). Furthermore, the Convention allows the bankrupt's creditors located in different States to introduce claims in the State where the bankruptcy proceedings were opened, and to receive adequate information about the proceedings.

4. European Communities (EC)

45. Efforts have been under way in the European Economic Community since the nineteen sixties to prepare a text on legal aspects of cross-border insolvency. The latest text being considered, the draft Convention on Insolvency Proceedings (1992), which the drafters have not yet released to the public, is, according to a written comment, not intended to harmonize the laws of the member States, but rather to construct legal conditions for handling cross-border bankruptcies in the EC by settling conflicts of laws and jurisdictions. To this end, the text is based on the notion that there should be one bankruptcy proceedings comprising all assets regardless of where they are located. The extent of universality may be limited by the possibility of the opening of one or more secondary proceedings, whose effects are confined to the territory of the States in which they were opened.

B. Other initiatives

1. The Hague Conference on Private International Law

46. The Hague Conference started work on regulation of bankruptcy in 1894. At its 28th session in 1928, the Conference decided to transform earlier drafts for a multilateral bankruptcy Convention into a model bilateral treaty. This model treaty was not widely adopted.

2. International Bar Association (IBA)

47. The International Bar Association formulated in 1989 a Model International Insolvency Cooperation Act (MIICA). The Model Act is based on the notion of universality and on the premise of a single administration of the insolvent debtor's assets wherever they are located.

48. The Model Act obligates the courts of enacting States to provide assistance to a foreign bankruptcy administrator. Such assistance may be: to make the debtor's assets available to the foreign bankruptcy administrator; to stay or dismiss an action against the debtor; to provide evidence relating to the insolvency; to recognize and enforce a foreign judgement; and to provide any other appropriate relief. The conditions for providing such assistance are: that the State of the bankruptcy administrator provides substantially similar treatment for foreign insolvencies as that provided in the Model Act; that the foreign court having jurisdiction over the bankruptcy administrator is a proper and convenient forum to supervise the insolvency proceedings; and that the administration of the property of the debtor in the respective foreign jurisdiction is in the overall interests of all creditors of the debtor. In case the requested court assistance is denied, the foreign bankruptcy administrator may commence insolvency proceedings in the State that denied the assistance.

CONCLUSIONS

49. The current lack of harmony among national rules governing cross-border insolvencies has often been noted as an obstacle to international trade. Attention has been drawn to the fact that, because of the disharmony of rules on issues such as cross-border effect of liquidation proceedings (above, paras. 11-16), international court assistance in insolvency matters (above, paras. 17-19), the right of creditors to participate in insolvency

proceedings (above, paras. 20-21), priority rules in the distribution of assets to creditors (above, paras. 22-24), cross-border effect of compositions between the insolvent debtor and creditors (above, paras. 25- 26), recognition of security interests created under a foreign law (above, paras. 27-30), or impeachment of debtor's transactions prejudicial to creditors (above, para. 31-32), the access of unsecured and secured creditors from different States to the debtor's assets is subject to obstacles, uncertainties and inequalities. A further negative effect of the disharmony of rules is that courts and legislators, in their tendency to protect creditors from their own territories, may be inclined to restrict recognition of foreign insolvency proceedings, may take measures favouring local creditors, and may be reserved in providing court assistance to foreign creditors. This situation may lead to several full-scale insolvency proceedings conducted simultaneously in different jurisdictions without meaningful coordination between them, which is wasteful, further increases the possibility of unequal treatment of creditors and may give rise to conflicts between actions of the various bankruptcy administrators.

50. It has been stated by commentators and associations of practitioners that it would be desirable to harmonize ground rules in some of the areas of insolvency law, which would allow international insolvencies, including compositions, to be resolved in a more predictable fashion and without undesirable conflicts between the jurisdictions interested in the insolvency. Views were expressed that it would be desirable to formulate a harmonized network of legislative rules that would enable a bankruptcy administrator, under certain conditions, to include in the assets from which the creditors will be paid also the debtor's assets located in a foreign State. One of the conditions for such extraterritorial effect of bankruptcy proceedings should be that the bankruptcy proceedings were initiated in accordance with harmonized rules on jurisdiction. Furthermore, the State requested to surrender assets to a foreign bankruptcy administrator should be allowed to ensure that specified local creditors are protected.

51. However, while recognizing the desirability of a workable system of cooperation between States in insolvency matters, it has also been pointed out in international discussions that it may be unrealistic to suppose that any principle of universality of insolvency proceedings could be attained at the global, or even at regional, level in the foreseeable future. It has been said that it will continue to be unacceptable that interests and expectations arising under local law could be overridden by the effects of insolvency proceedings taking place elsewhere.

52. The Commission may wish to bear in mind the foregoing views in determining whether it would be worthwhile for it to consider the matter in depth. Among the primary objectives of the in-depth consideration would be to identify the aspects of international insolvency law that lend themselves to being harmonized and the most suitable vehicle for the harmonization, such as a multilateral treaty, model law or a model bilateral treaty.

53. In the context of considering the foregoing issues, the Commission might also wish to study the question of possible effects of the opening of insolvency proceedings on relationships or proceedings beyond those comprised in the insolvency proceedings. For example, if, in the context of a bank guarantee, the principal becomes subject to insolvency proceedings, it may be useful to clarify whether there is any justification for the bank to suspend payment or terminate the guarantee on the ground that the proceedings reduce

the bank's ability to obtain reimbursement from the principal. A similar issue may arise in the context of a letter of credit when the applicant for the issuance of the letter of credit becomes subject to insolvency proceedings. In another example, when in an international arbitration the defendant becomes subject to insolvency proceedings, the question may arise whether the opening of the proceedings should have any effect on the arbitration. Such effects of insolvency proceedings on other relationships or proceedings are often determined not in the law on insolvency proceedings but in the law governing the respective relationship or proceedings.

54. Should the Commission consider the project useful, it may wish to express preliminary views on the direction of the future work and request the Secretariat to prepare, in consultation with other relevant international organizations, including the Hague Conference on Private International Law, for a future session of the Commission a study on the feasibility of harmonized rules on international insolvencies.